

Letter of Findings: 08-0681; 08-0682
Individual State Income Tax
For 2005 and 2006

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ISSUE

I. Research Credit – Individual Income Tax.

Authority: [IC 6-3-1-3.5](#)(a); IC § 6-3.1-4-1; I.R.C. § 41(c)(3); I.R.C. § 41(c)(3)(B)(ii); I.R.C. § 41(f)(1)(A)(i); I.R.C. § 1361; I.R.C. § 1563(a)(1)(B); Treas. Reg. § 1.41-6(b)(1); Treas. Reg. § 1.41-6(b)(2).

Taxpayer challenges the Department of Revenue's decision adjusting the S-corporation's amount of Indiana Research Credit which could be claimed and the consequent imposition of additional income tax.

STATEMENT OF FACTS

Taxpayers collectively and individually own an Indiana S-corporation. The Department of Revenue (Department) conducted an audit review of the S-corporation. Among other adjustments, the audit review reduced the S-corporation's Indiana Research Credit. The reduction resulted in additional income being subject to Indiana income tax. Because the S-corporation's additional income tax liability "flowed through" to the taxpayer/shareholders, taxpayers became liable for the additional assessment. Taxpayers protested, an administrative hearing was conducted during which taxpayers' representatives explained the basis for the protest, and this Letter of Findings results.

I. Research Credit – Individual Income Tax.

DISCUSSION

The S-corporation consists of a parent corporation, four Qualified Subchapter S Subsidiaries (QSSS), and one single member Limited Liability Company (SMLLC). Each of the QSSS's and the SMLLC are disregarded as separate entities from the parent.

The Indiana Research Credit gives taxpayers a credit against their taxable income for research expenses that exceed a certain base amount. The base amount is calculated using a "fixed base percent" derived from a formula that calculates a taxpayer's aggregate qualified research expenses over a set period of time. "Start up" companies – those that do not have a history of prior year research expenses – have special rules.

Determining the amount of the Indiana Research Credit requires that the average annual Indiana gross receipts of the four preceding years be multiplied by the taxpayer's fixed base percentage. IC § 6-3.1-4-1. The Department's audit used a base percentage of three percent. Taxpayers disagree arguing that a base of 1.06 percent be used. The S-corporation itself originally claimed the three percent base credit amount and it was only after the audit adjustment was made that taxpayer made the claim that it was entitled to the 1.06 base percentage.

The difference between the audit and the taxpayers' claim can be significant. For example, if the taxpayers' (the S-corporation) earned average Indiana annual receipts of \$1,000,000 during the four years at issue, that amount would be multiplied by the three percent fixed base resulting in \$30,000. If the taxpayers' current year research expenses were \$50,000, the taxpayers would be entitled to claim as a credit the amount **in excess** of the \$30,000; in this example, taxpayers would be entitled to claim \$20,000 as a credit for that current year.

However, accepting taxpayers' assertion – that the fixed base percentage is 1.06 – produces a different result. Multiplying the same \$1,000,000 in average Indiana annual receipts by 1.06 percentage results in \$10,600. If the taxpayers' actual current year research expenses remained at \$50,000, the taxpayers would be entitled to claim as a credit the amount **in excess** of the \$10,600; in the result as posited by the taxpayers' example, taxpayers would be entitled to claim \$39,400 as a credit for that particular current year.

Plainly, taxpayers favor employing the 1.06 percentage because it allows them to claim a larger amount of credit.

The Department's audit chose to employ the three percent fixed base amount because it found that the S-corporation (the "parent" as described above) should be classified as a "start up" company for research credit purposes. As stated in the audit report, "This percentage (three percent) is used for federal tax purposes when a new 'start-up' company is included to calculate the credit." The audit is correct in that if there was no history of research expenses, the Internal Revenue Code reverts to a fixed, preset amount. I.R.C. § 41(c)(3)(B)(ii). The audit report further points out that the three percent is correct because one of the QSSS subsidiaries was incorporated in 1995 and did not exist when the research credit came into effect in the 1980's.

The audit report is correct when it notes that the S-corporation (as presently constituted) did not exist until April 15, 2004. However, one of the QSSS's was incorporated in 1979 and made its S-corporation election in

1988. That particular QSSS had qualified research expenses during the 1980's and computed their fixed base percentage at 1.06 percent.

The issue is whether the S-corporation – consisting of the parent and five subsidiaries – is entitled to claim the 1.06 base percentage credit or whether the entire group should be considered a "start-up" group and limited to claiming the less advantageous three percent base credit. It was the audit's conclusion that because the parent did not spring into existence until April 15, 2004, that it was limited to the three percent base credit. It is the taxpayers' opinion that the entire S-corporation can "bootstrap" itself into qualifying for the 1.06 percent base credit because one of the subsidiaries qualified for the research expense credit as determined during that subsidiary's 1984 through 1989 fiscal years.

I.R.C. § 41(c)(3) states that, "Except as otherwise provided in this paragraph, the fixed-base percentage is the percentage which the aggregate qualified research expenses of the taxpayer for taxable years beginning after December 31, 1983, and before January 1, 1989, is of the aggregate gross receipts of the taxpayer for such taxable years." Indiana, of course, "piggybacks" on the federal tax rules. [IC 6-3-1-3.5\(a\)](#) states that "When used in this article, the term 'adjusted gross income' shall mean the following... In the case of all individuals, 'adjusted gross income' (as defined in Section 62 of the Internal Revenue Code)...." IC § 6-3.1-4-1 applies the I.R.C provision specifically to the Indiana calculation stating that "'Indiana qualified research expense' means qualified research expense that is incurred for research conducted in Indiana." (Emphasis added).

I.R.C. § 41(f)(1)(A)(i) states that, "In determining the amount of the credit under this section (i) all members of the same controlled group of corporations shall be treated as a single taxpayer...." In addition, Treas. Reg. § 1.41-6(b)(1) states in part that, "All members of a controlled group are treated as a single taxpayer for purposes of computing the research credit."

Treas. Reg. § 1.41-6(b)(2) states that, "For purposes of computing the group credit, a controlled group is treated as a start-up company for purposes of section 41(c)(3)(B)(i) if... [t]here was no taxable year beginning before January 1, 1984, in which a member of the group had gross receipts and either the same member or another member also had qualified research expenditures (QREs) or... [t]here were fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989, in which a member of the group had gross receipts and either the same member or another member also had QREs."

The S-corporation – consisting of the parent and its subsidiaries – is entitled to be treated as a "controlled group" under I.R.C. § 41(f)(5) because it is qualified as such under I.R.C. § 1563(a)(1)(B). The S-corporation consists of a common parent which owns at least 50 percent of the subsidiaries' combined voting power of all classes of stock.

Since the S-corporation had a member of its controlled group – the 1979 QSSS – which had both receipts and qualified expenses prior to January 1, 1984, and since that same member had more than three years of gross receipts and qualified expenses during the 1984 through 1988 period, the "combined group" cannot be considered as a "start-up group" for research credit purposes. Therefore, the fixed base percentage is the fixed base percentage of the 1979 QSSS which had both receipts and qualified expenses during 1984 through 1988. Taxpayer provided documentation established that the fixed base percentage for the QSSS was 1.06 percent, a figure applicable to the entire controlled group. In effect, the qualified subsidiaries of S-corporation are enveloped into the parent. See I.R.C. § 1361.

FINDING

Taxpayer's protest is sustained.

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